New FSA Final Guidance FG12/15 highlights SRI and Ethical Investment advice

On 6 June 2012 the FSA published its Finalised Guidance (FG12/15) paper clarifying the areas of independent and restricted advice. This is an important paper for everyone in the retail market and has far reaching implications.

For those working in retail SRI (or considering this area) it is noteworthy as it mentions 'ethical and socially responsible investment' many times.

This paper may benefit from additional digestion on my part over time, but as it mentions SRI/ethical investment in a number of places I have taken time to go through it as early as possible, commenting on the areas that have implications for what I call 'sustainable and responsible investment' (SRI) advice.

I have included analysis - and some personal opinions - on the areas adviser should think about in the run up to 1 January. Please be aware - these are personal views, based on my 20 years experience in financial services - and as an SRI specialist. I am however neither an authorised adviser, a lawyer or a compliance specialist!

> **Key**
> **Text** copied from the FSA paper is shown in blue.
> The areas of the FSA text that I believe may be most pertinent to the SRI market or where SRI is specifically referenced are in blue and in **bold.**

I strongly recommend advisers read the FSA paper first hand - in order to form their own opinions. See link below.

FG12/15: Independent and restricted advice

http://www.fsa.gov.uk/library/policy/final_guides/2012/fg1215

FSA Finalised Guidance paper June 2012

"Retail Distribution Review: Independent and restricted advice"

Contents

Summary

A view on the key points for SRI advice outlined in FSA FG12/15

The recent FSA paper FG12/15 is broadly constructive for SRI. It indicates that advisers should include areas such as SRI in their 'personal recommendations' (advice processes) - even if they do not fit their standard business models or tools - as advice must be centred on the client's needs. It also clarifies that - providing all relevant rules are met - independent advisers can specialise in SRI / ethical investment or other 'relevant markets'.

As such it opens the door for more independent advisers to market themselves as specialists (in SRI or other areas). And in addition - the high profile given to ethical investment and SRI in this paper rather puts to bed the view that it can be ignored on a whim.

The following bullets are a 'précis' of the more detailed text below. Both include opinions as well as excerpts from - and references to - the FSA paper.

- Independent advisers can restrict themselves to only offering ethical / SRI products to clients who identify themselves as only being interested in that market. (2.6, 2.12 both specifically mention ethical/SRI)
- Investment needs and objectives must be assessed on an individual basis so it will be rare that independent advisers will be able to rule out entire product areas even if they specialise. (2.7)
- If an adviser can identify a common market across all their clients (and market themselves as specialising in that area) they may be able to exclude certain retail investment products from the advice process (2.8)
- Common relevant markets are likely to be few in number but as well as ethical/SRI clients (explained in 2.6) this could include 'Islamic Finance and charities and trusts (and annuities)' (2.13 refers specifically to these latter three areas)
- Advice must be fair, comprehensive, unbiased and unrestricted (2.14)
- Advice on retail investment products must relate to clients' needs (2.15) – not adviser processes or tools.
- Panels need to be sufficiently wide to enable advice to be comprehensive and fair (5.4).
- Advisers who use panels should be able to go off panel for areas such as ethical/SRI investment to find funds that meet clients' needs. (5.5 specifically references ethical/SRI)
- Platforms and model portfolios are viewed similarly to panels. If an adviser's regular platform or portfolio solution does not meet the needs of an individual client - the adviser must look for alternative solutions that meet the needs of that specific client (to meet the '…comprehensive and fair analysis of relevant product markets' rules – 5.6, 5.7, 5.12).
- Some areas could be subject to further queries – for instance regarding company names (2.9) and PI cover (2.15).

FG12/15 starts with an introductory section and moves on to explain what constitutes 'independent' advice as follows:

The standard for independent advice

2.1 'Independent advice' is defined in the Handbook as *'a personal recommendation to a retail client in relation to a retail investment product where the personal recommendation provided meets the requirements of the rule on independent advice (COBS 6.2A.3R)'.*

2.2 The requirements of the rule on independent advice ('the standard for independent advice') are that the personal recommendation[2] is:
(a) based on a comprehensive and fair analysis of the relevant market; and
(b) unbiased and unrestricted.

The paper then defines the main 'product' areas as…

Retail investment product

2.3 'Retail investment product' is defined in the Handbook as:
(a) a life policy; or
(b) a unit; or
(c) a stakeholder pension scheme; or
(d) a personal pension scheme; or
(e) an interest in an investment trust savings scheme; or
(f) a security in an investment trust; or

> *(g) any other designated investment which offers exposure to underlying financial assets, in a packaged form which modifies that exposure when compared with a direct holding in a financial asset; or*
> *(h) a structured capital-at-risk product;*
> *whether or not any of a) to h) are held within an ISA or a child trust fund (CTF).*

The paper goes on to discuss 'relevant markets' as follows ...

> **Relevant market**
> 2.6 COBS 6.2A. says that a relevant market should '*comprise all retail investment products which are capable of meeting the investment needs and objectives of a retail client*'. **For example, if a client indicates that they are only interested in ethical and socially responsible investments, it is clear that there is a range of products that would never be suitable for them, namely non-ethical investments. Their relevant market would exclude non-ethical investments, and an adviser would not need to consider these products when forming independent advice for such a client.** So, a relevant market in the context of the standard for independent advice is defined by a client's investment needs and objectives and not, for example, by product or service types.

This indicates that advisers can identify clients as only being interested in ethical /SRI 'products' and so for these clients SRI is their 'relevant market' - and other 'non ethical' investment are not relevant to them.

I welcome the FSA's recognition of the existence of such clients as they most definitely exist in not insignificant numbers - and indeed ethical/SRI products can be their only appropriate solution. From experience however , I would urge caution here for non-specialist advisers.

Most investors interested are not looking to hold only 'strictly screened ethical funds' (although of course some are!). In my view it is important the FSAs view is not interpreted as meaning this as it is far more common for investors either to want to hold a combination of responsible, sustainable, environmental and ethical funds (perhaps majoring in one area). They may even wish to hold them alongside some 'non-SRI' products - particularly if they have not sought specialist advice. Mixing and matching both across the many different SRI styles - and between SRI and non-SRI strategies - is far more common than most advisers realise.

The following two points touch on issues relating to developing a specialism.

> 2.7 '**Investment needs and objectives' need to be assessed on an individual client basis,** so we do not believe it possible that many firms can say unequivocally upfront what products may be capable of meeting the investment needs and objectives of their clients. We expect, therefore, that the majority of firms providing independent advice will need to be able to provide advice on all types of retail investment products. **A firm could decide that it will specialise in certain financial situations**, for example saving for retirement, but that **does not necessarily mean that it can rule out in advance advising on certain retail investment products** if it provides independent advice.
>
> 2.8 However**, if a firm can identify a common relevant market across all of its clients that does not include certain retail investment products**, it would not need to consider such products when giving independent advice. **To not consider certain retail investment products, the firm would need to be able to market itself in a way that attracted only the intended type of clients,** and only take on the intended type of clients. This would mean that both the firm and consumers would need to be able to **easily identify** whether the **consumers' relevant market matched the firm's** specialism, for the firm to provide independent advice.

As such, independent advisers normally need to be able to advise on all markets but can - if they chose - specialise (and market themselves as specialising) in an area that is relevant to their current and future clients. Likewise, there may be areas an adviser does not wish to be involved in. Both scenarios appear to be possible providing the adviser meets the needs each individual client.

Advisers need to understand and meet the needs of their clients - and can - if they wish, promote themselves as specialising in a particular area - such as ethical or sustainable/socially responsible investment.

As such SRI specialists don't have to worry about losing independent status and no one is obligated to advise on SRI – but all advisers do have to ensure they understand and meet their clients' individual needs.

So far so good...

The paper then goes on to say...

> 2.9 If a firm chooses to specialise in a particular relevant market, *'it should not hold itself out as acting independently in a broader sense. For example, a firm "Greenfield", which specialises in **ethical and socially responsible investment**, should not hold itself out as "Greenfield Independent Financial Advisers". "Greenfield – providing independent advice on ethical products" **may** be acceptable'* (COBS 6.2A.4G(2)).

This paragraph has me a little foxed as it appears to contradict 2.6. To my mind if an adviser specialises in 'green' issues and is authorised as independent it seems odd not to be able to promote themselves as such through their name.

I suspect this may be an area of future debate, but in the meantime it may be worth seeking clarification for those advisers who could inadvertently be caught out by this rule.

The next section then clarifies the need for all advisers to cover all areas - or disclose if they do not - and ask 'initial questions' of prospective clients to be sure they are attracting the right clients:

> 2.10 In terms of disclosure, *'if a firm provides independent advice in respect of a relevant market that does not include all retail investment products, a firm must include in the disclosure an explanation of that market, including the types of retail investment products which constitute that market'* (COBS 6.2A.6R(2)).
>
> 2.11 We would expect a firm not to rely solely on disclosure to ensure it only takes on clients whose relevant market matches the firm's specialism. For example, a firm should **ask initial questions** of prospective clients to determine whether their investment objectives and needs **align** with that of its target market.

The following paragraphs also contain further welcome clarification about how and when a firm can hold itself out as being a specialist 'independent' adviser... clarifying that this is possible.

> 2.12 In the rules, we use an **example of ethical and socially responsible investments** as a market that a firm **could specialise in and hold itself out as independent because it appears to meet the tests described above**, i.e.:
>
> - if clients indicate that they are **only** interested in **ethical and socially responsible investments**, then a firm would **not need to consider** investments that do not meet this criteria, and can therefore narrow the range of products that it gives advice on;
> - clients should be able to easily identify a **preference for ethical or socially responsible investments,** and so be able to **self-select with a high degree of accuracy;**
> - a firm should be able to market itself in a way that **only** attracts clients with a **preference for ethical and socially responsible investments**; and
> - a firm should be able to **easily confirm** whether its service is **appropriate for each new client**, i.e. that it can consider all of the products within each client's relevant market.

Section 2.13 then discusses other possible 'common relevant markets' in which an adviser could specialise – this, notably, includes **Islamic Finance** and **trusts and charities** – as well as a small number of specific product areas such as annuities.

Comprehensive, fair, unbiased and unrestricted

The following sections then relates to all advisers. It supports the view that all advisers should ask an SRI fact find question - and have robust processes in place that enable them to advise on areas such as SRI - even if is not of particular interest to the adviser.

> **'Comprehensive and fair analysis', 'unbiased and unrestricted'**
> 2.14 This section sets out some of our expectations on meeting the standard for independent advice, in particular the twin tests of being **'based on a comprehensive and fair analysis of the relevant market**' and '**unbiased and unrestricted'**, whether or not a firm is specialising in a relevant market.
>
> *Excluding product types from consideration*
> 2.15 If a firm **cannot or will not advise** on a particular type of retail investment product, and that product **could potentially meet the investment needs and objectives of its new and existing clients, then its advice will not meet the standard for independent advice**. In other words, the justification for a firm excluding types of retail investment products from its range needs to be **centred on the client**. As an example, the fact that a firm's professional indemnity insurance policy specifically excludes certain products would not be a valid reason for never advising on such products.

This highlights advisers' obligations to understand the needs of each of their clients – which is normally carried out with the help of a fact find questionnaire.

This is not new, but given that ethical/SRI needs are highlighted in this text this does appear to indicate advisers should not overlook this area. As such, advisory firms should in my view consider whether or not they have processes in place to effectively advise on SRI in order to offer 'comprehensive... fair... unbiased and unrestricted' advice.

On a 'non SRI' related note - point 2.15 raises alarm bells regarding PI cover (and I have others to thank for bringing this to my attention). To explicitly direct advisers to consider products for which they have no PI cover seems surprising. This could leave both clients and advisers exposed in the event of a problem. Whether the solution to this is for advisers to change their PI provider, buddy up with other advisory firms with appropriate PI cover or seek further clarification from the FSA I don't know. But as it stands this looks unsatisfactory – even given the clarification regarding UCIS and other areas (2.16 – 2.18).

Panels, Platforms and Model Portfolios
With regard to the use of panels, platforms and model portfolios the paper brings useful guidance:

> **Panels**
> 5.4 A firm can use research to distil the product market into a panel and then select a product from the panel when giving independent advice.
>
> ***A firm would need to ensure that any panel is sufficiently broad in its composition to enable the firm to make personal recommendations based on a comprehensive and fair analysis****, is reviewed regularly, and that the use of the panel does not materially disadvantage any retail client* (COBS 6.2A.18G).
>
> *When using a panel a firm may exclude a certain type or class of retail investment product from the panel if, after review, there is a valid reason consistent with the client's best interests rule, for doing so* (COBS 6.2A.19G). For example, a firm may feel that certain products have a high level of risk that is not appropriate for its client base and so exclude them from its panel.
>
> 5.5 However, a firm that provides independent advice **needs to be able to advise off-panel** if that would be in the best interests of a particular client. To do this, its advisers should **maintain an awareness of what is and is not included in the panel, so they can identify clients for whom an off-panel solution would be suitable. For example, if a client wants ethical investments and a firm does not have a product on its panel that is consistent with this preference, we would expect the firm to review the market for a suitable ethical product.**

Platforms

5.6 **A similar rationale applies to the use of platforms** – as well as discount brokers and other channels for buying investments – as for panels. A firm can use platforms in providing independent advice, but need to remain aware of the limitations of its chosen platform and advise 'off-platform', or through another platform, where this is best for a client.

5.7 The current market is changing on a frequent basis and – generally – platforms do not offer products from the whole of the retail investment product market. So, in the current market, we expect it to be very rare, if possible at all, that a firm could use a single platform for all of the investment business of all of its clients and meet the standard for independent advice.

Model portfolios

5.12 If a firm is constructing its own model portfolios, which include one or more retail investment products, for use in providing independent advice, it should ensure that it bases its selection of retail investment products on a **comprehensive and fair analysis of relevant product markets**. If a firm is using model portfolios constructed and managed by a third party, it should ensure the criteria used by the third party to select retail investment products are sufficient to allow the firm to meet the independent advice rules.

5.13 Before recommending a model portfolio, a firm should consider each product in the model portfolio within the context of the whole portfolio, in light of the client's individual circumstances. For example, **a client may have preferences** about the types of investments they wish to make, such as **ethical or socially responsible investments**, or have existing exposure to sectors or assets held within the model portfolio. The model portfolio as a whole, rather than the individual products held within it, should be considered when determining whether the model portfolio is suitable given the client's attitude to risk.

5.14 **If any aspect of the model portfolio is not suitable or consistent** with the client's investment needs and objectives, then either: 1) the model portfolio should not be recommended; or 2) the model portfolio should be tailored so that it is suitable (which would make it a 'bespoke portfolio'). In addition, the firm should consider whether use of the model portfolio as a whole is in its client's best interests, which will entail, among other things, ensuring that the model portfolio charges are appropriate for each individual client's circumstances.

These points make it clear that the use of panels, platforms and model portfolios offer no reason for ignoring areas such as SRI. Advisers are able to orientate their business however they wish, but the recommendations they make should fit the needs of the individual investor - not the adviser's business model.

The next section of the paper relates to Discretionary Investment services. Although it does not make specific reference to SRI this will be relevant to many advisers. See points 5.16 – 5.21 if you are involved in this market.

Other related FSA information:
Recent information on unregulated investment (which features only very briefly in FG12/15) may also be relevant to advisers who are looking into this area. There is also a recent FSA fact sheet on this topic - and more information is awaited. These will no doubt be of interest to advisers with wealthier clients particularly with reference to the increasingly interesting area of 'impact investment'.

Feedback and comments welcome!
I hope you have found the above comments useful. I would very much welcome your opinions on the views I have expressed here and am of course happy to discuss ideas about how you might offer SRI post 1 January.

Please respond to Julia@srsiservices.co.uk. (I apologies for having to remove the 'Comments/Reply' facility on my blog, this was because of spam.)

Kind regards,

Julia

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For information tips and tools to help you offer SRI to your clients see www.sriServices.co.uk.